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MEMBERSHIP OF STATE BANKS IN THE FEDERAL RESERVE SYSTEM.

Address by

George M. Reynolds, President, Continental and Commercial
National Bank, Chicago,

At the

Convention of the American Bankers' Association held at
Richmond, Va., October 13th, 1914.

In maintaining the position that it would be a wise and conservative course for the State banks to defer entering the Federal Reserve Banking system at this time when the twelve Regional banks are about to become operative, I wish to have it understood that this attitude on my part does not reflect a desire to in anywise question the general and ultimate efficiency of the new Federal Reserve law.

I have so often gone upon record in my public utterances as being in favor of the principal features of the law, that my position is, I believe, clearly understood.

That my pledge of loyal support to any legislation that I believed would be in the interests of the welfare of the people and the country in general was sincere, is proven by my acceptance of a directorship in the Federal Reserve Bank of Chicago with its manifold duties that add so materially to my already large responsibilities.

The assured success of any institution or business is based upon the ways and means that represent tried and established precedents, and we should, therefore, all be conservative in the adoption of any new policies which are more or less of an experimental nature.

Please do not understand that I question the applicability of the new law to the successful conduct of the business of State banks, but since the object of this assemblage is to discuss and have an interchange of opinions on this subject which is of so great importance to the many banking institutions of this country doing business under State charter, I invite your attention to a few of the features which I believe concern you most.

The inauguration of the Federal Reserve Banks will take rank with the most notable phases of financial history. Think of what it means to materially alter the methods of providing the medium of exchange, and of safeguarding the reserves, for as wonderful and extensive a country as the United States, —a country with ninety-odd millions of the world's most energetic and alert people, served by upwards of 25,000 banks. The task of making this change calls for ability, foresight and conservatism, especially the latter, in order that what is done may not have to be undone.

Having reached the point where we are compelled to act

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always be a source to which they may go for the currency. They will no longer be obliged to respond to requests by saying the limit of ability to make advances has been reached. This power will be restricted only by the percentage of reserves and the amount of eligible paper on hand, with the qualification, of course, that a condition of inflation did not exist that would demand contraction instead of expansion of bank notes.

Under a recent amendment the State banks, if members, would be able to secure Aldrich-Vreeland emergency notes through National Currency Associations; but Senate Bill No. 6,398 would confer this privilege irrespective of membership. This bill passed the Senate the eleventh day of September and was referred to the Committee on Banking and Currency of the House. The Committee reported it back with this provision stricken out. If the proposed amendment should become law in the form in which it passed the Senate one of the incentives to membership will have been removed. If, on the other hand, the law should remain as at present, the right to procure the Aldrich-Vreeland notes direct should not be sufficient inducement to the State banks, because the National banks are in position to supply them with all the emergency currency they can use, and can surely put out as much of it as would be prudent. Every man who has given serious thought to the subject knows inflation would be harmful at any time, and especially now, when as a result of the most destructive war ever known, there is in nearly all Europe an unquenchable thirst for our gold; and the larger the volume of note issues the greater the danger of foreign encroachment upon our stock of the yellow metal to a degree that would sound a note of alarm and possibly jeopardize the banking situation. There is in this no intimation that one set of banks is more apt to abuse this privilege than the other, but I merely wish to emphasize the fact that there is no demand for currency which can only be satisfied by the State banks making special effort to avail themselves of this provision of law. This may be illustrated by reference to the situation with which the country was confronted two months ago, and it must be conceded to have been one of stress. We got safely through the worst of the storm without needing anywhere near all the emergency notes the National banks are allowed to issue.

Measured solely by the banking power of the United States, which according to the Comptroller's report for the year 1913, was \$22,600,000,000, exclusive of non-reporting banks, there is no argument to sustain an effort to have the State banks join now. Of the total, the 7,473 then existing National banks contributed \$8,789,000,000, or almost 39 per cent., and the 18,520 State banks \$13,829,000,000. Thus it will be seen

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pletely, thus throwing the plant or portions of it out of commission. The output might be so curtailed as to interfere with the filling of orders; customers might be lost to the concern. Really capable management would adopt a different policy. Some new machinery would be installed and if superior to the old, the substitution would go on gradually, and the operatives would be given opportunity to acquaint themselves with the more modern plant equipment. The officers of a railroad would never substitute untried appliances on all its cars or engines at one stroke. The hazard would be too great. There might be vexatious delays of trains, wrecks and loss of life, or the destruction of property. The veteran railroad man would set apart a few cars or locomotives for experimental purposes, and if the apparatus made for efficiency and economy, all the rolling stock would be equipped in due time.

The banks and the currency occupy the same relation to the people and their prosperity as do the capital of the merchant to his business, the machinery of the factory to its output, or the equipment of the railroad to its operation. All interests have a right to expect that this transition from the old to the new will be made gradually, for the clogging or sudden disarrangement of the banking system would be disastrous to labor, agriculture, manufacturing and commerce. Everyone in the community has a deep interest in the stability of the banks and the soundness of the currency, because through the banks and by means of the currency, all business is transacted at some stage. If the banks are not prosperous, or are unduly encumbered with impractical currency features, it means that a hardship will fall upon all the people.

The rate of interest promised on the investment is not sufficient attraction to most of the State banks. The maximum is six per cent., and in the towns and smaller cities of many sections, there is a big demand for all available money at as high and even higher rates. This is especially true in the south and west. So from the standpoint of assured earnings on the amount required for stock in the Reserve bank, there is no reason why State institutions should do other than adopt a waiting attitude.

The advocates of the theory that the State banks should enter at the beginning will probably direct attention to the facilities for collecting checks and drafts at little or no cost, and also to the advantage of having checks and drafts on member banks pass at par among other member banks wherever located. But there are two sides to this. One is that it is doubtful if, for a few years, more items will be handled at par, for banks, than have been cleared free of cost in the past through the large collecting banks who place extensive par lists at the disposal of correspondents. The other is that membership will carry with it the obligation to abide by the

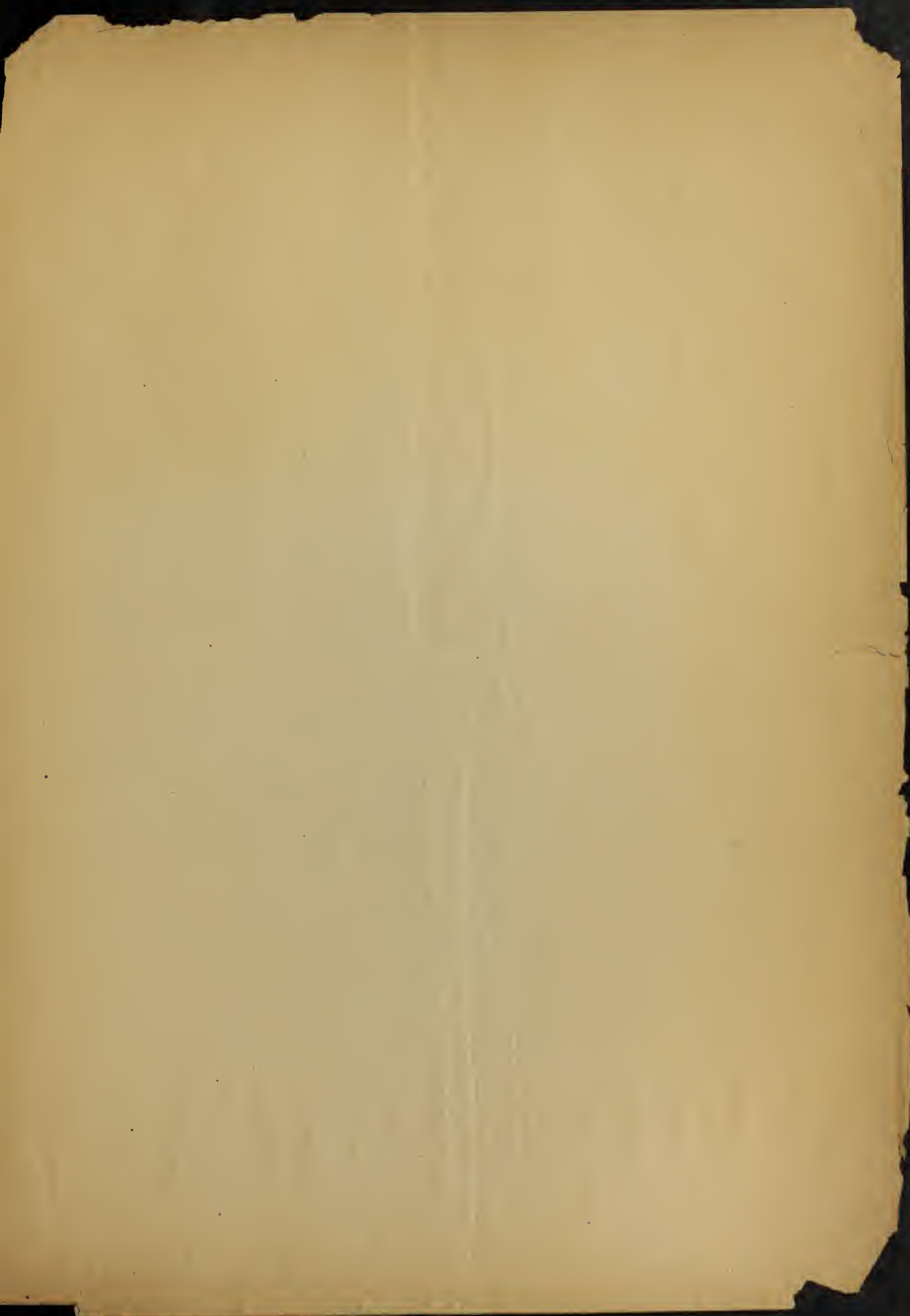
This nation is bound to continue its commercial expansion and growth in financial power, and as this process goes on, I hope all our banks, both State and National, will be joined together in one strong system.

To reiterate, I am not opposed to the State banks joining after it has been shown that the Federal Reserve System is successful. I have only recommended deferring the time in order that the question may be decided intelligently and through the experience gained in the actual operation of the Reserve banks. This is preferable to taking action now, as the National banks are compelled to do. It is settled that about forty per cent. of the banking power of the country is committed to this system. If it works successfully, as I hope it will, all will be well and good. If, however, the operation of the system shows that our present expectations for it are not well founded, it would be far better that the 60 per cent. of the banking power of the United States represented by the State banks remain outside as a steady influence in business until readjustments can be effected. In other words, let the principles of sound economics direct our activities until a natural level is reached in the change from the present to the new order of things. After the change has been made by the National banks, every State banker can, in the light of experience, pass judgment upon the system, and determine for himself whether it is advisable for his particular institution to become a member.

One of the points that has engaged the attention of a large number of bankers and writers upon the subject of banking is the shifting of reserves. Under the most favorable conditions this will necessitate a considerable shifting of all credits, and it is one of the most delicate problems with which the banking fraternity will have to deal. The burden of making the transfer from correspondents to the Reserve banks will place a heavy strain upon the banking resources of the country if no other than National banks attempt it within the allotted three years, but if the process is extended to the State banks, the load will be more than doubled and correspondingly harder to carry.

The reserve requirements of the act are more stringent than those of some of the States, and less so than those of other States. In still others no specific amount of reserve is required. Be this as it may, the Federal statute will, at the expiration of thirty-six months, compel member banks to carry their total reserves in their own vaults or in the Reserve banks, thereby depriving them of the interest paid on that portion of this fund on deposit with correspondents. In the course of a year this loss would amount to a snug sum.

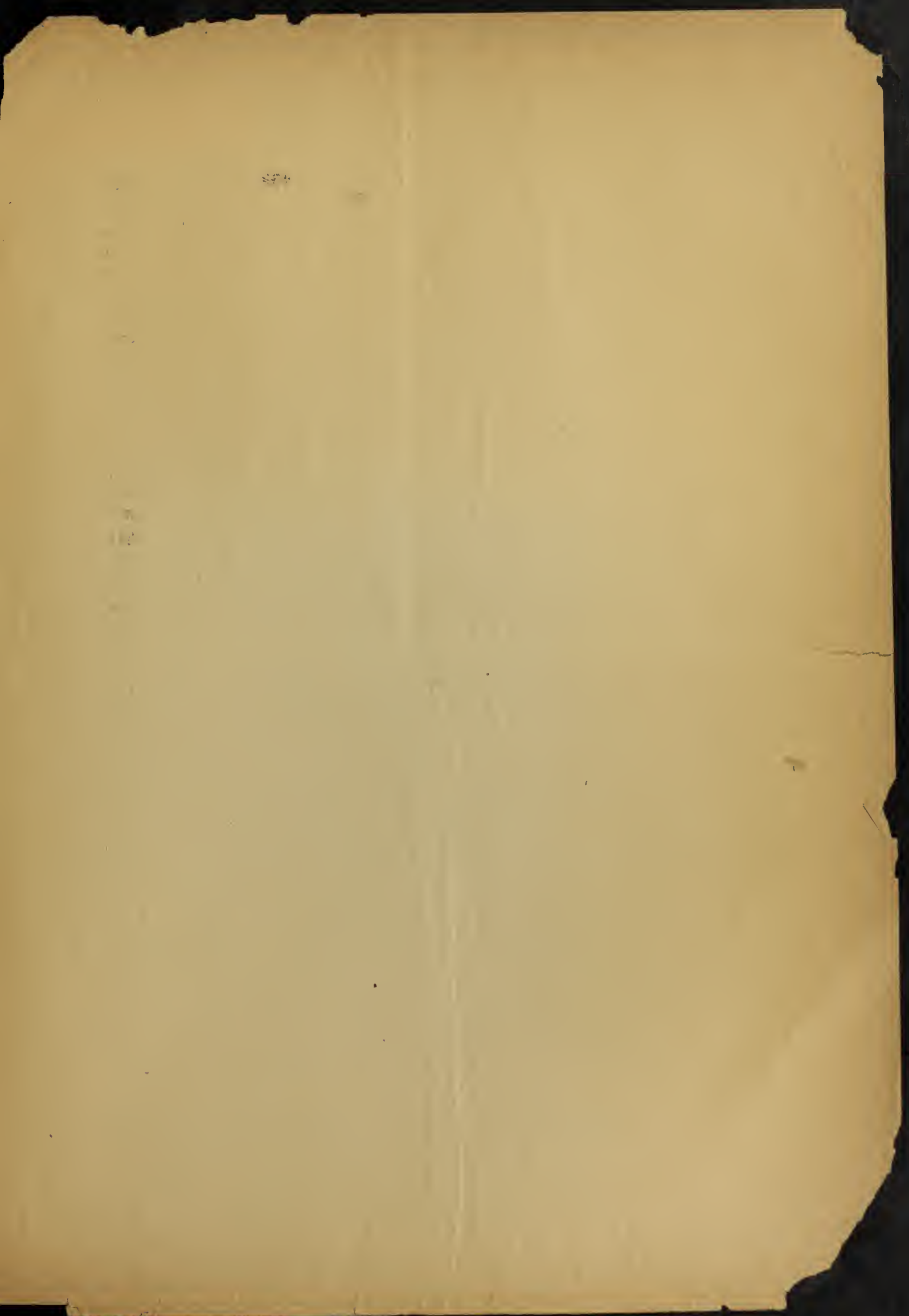
possibilities that through this section of the bill all member banks, both National and State, may suffer considerable loss in revenue heretofore derived from exchange and collection charges. Ultimately all banks in towns where there is competition will have to meet the exchange and collection rates prescribed by the Federal Reserve Board or lose patronage. The reserve requirements of the act are more stringent than those of some of the States, and less so than those of other States. In still others no specific amount of reserve is required. Be this as it may, the Federal statute will, at the expiration of thirty-six months, compel member banks to carry their total reserves in their own vaults or in the Reserve banks, thereby depriving them of the interest paid on that portion of this fund on deposit with correspondents. In the course of a year this loss would amount to a snug sum.



that the banking power represented by the former, which will all be directly allied with the new system, leaves no room for doubt about the sufficiency of the trial to be given it. This being true, certainly no one can claim lack of loyalty to the administration or lack of interest in the successful operation of the Reserve banks on the ground that the State institutions are postponing action on the question until the law has been actually demonstrated. Delay will not in any manner indicate that they are throwing obstacles in the way of the Federal Reserve Board or the boards of the Reserve banks. On the contrary it may be taken to mean a disposition to leave these bodies unhindered while working out the details. In all candor it appears to me that the cementing of the unity of the National banks under one leadership, so to speak, will prove quite a large initial undertaking. The idea of placing nearly nine billions of dollars of banking power into an organization over which the final control will rest with seven men is almost enough to stagger the imagination. There is no justification for hurry in adding almost fourteen billions more.

Viewed from whatever point you will, the entire banking power of the country should not be committed to the plan for at least two or three years. If there are serious imperfections it would be far better for the entire country that at least sixty per cent. of the banking power maintain its freedom from the system.

There is the possibility that actual tests will disclose weaknesses in the most carefully drafted statutes. We are not sure that this one will not be found defective in parts, and as it is not a foregone conclusion that individual member banks will, in the beginning, really be better off than non-member banks, it certainly does not appear that the number and capital involved should be voluntarily raised until experience exposes and the Congress removes the defects, if any are shown to exist. We must bear in mind that the bill was not framed for the purpose of adding to the profits of member banks; the intention was to enable the banking system to adequately meet the needs of modern business. It is from that fountain that the good to the banks is supposed to spring. Therefore, if a sufficient number of institutions join to make it a success, all the banks whether members or not, will share in the main benefits. If the plan is shown to have the merits claimed for it, the State banks will, of course, want to come in, and they may do so at any time, but once the union has been effected there is no way of breaking the bond, so far as I have discovered, except through the process of liquidation. A forehanded merchant will not risk more capital in a new venture than is necessary to thoroughly try it out. He will realize that if the enterprise is profitable more money can be invested in it as conditions warrant. The management of a manufacturing company would not want to change all the machinery in its plant at one time. They would naturally fear confusion, and friction in operation, if nothing else. Some part of the new machinery might not do the work as well as expected; it might be weak in spots and break down com-



more than a third of the individual banks into twelve groups or districts, each district to have as its head a Federal Reserve Bank, there should be further inquiry and deliberation as to the desirability of having the full banking power, so far as it is represented by incorporated institutions, join the new system at the outset. It is of direct concern to everyone, and vital to the success of the plan, that in its initial operations, it be kept as free as possible from cumbersome machinery. If this can be accomplished there will be less likelihood of costly mistakes.

This view raises the question as to whether it is the part of wisdom to keep the membership down to the minimum in members and capitalization for a while, or to urge State banks to join now. There appear to be many reasons why they should not be so urged, but, rather, counseled to remain non-members for the present.

There seems to be doubt in some States as to whether the laws would permit ownership of stock that would entitle them to membership. While I am aware that some Attorneys-General have rendered opinions in the affirmative (and all may have done so), these are the conclusions of only one man, or, at most, one department of the State, and inasmuch as there is absolutely no urgency it would seem logical to await legislative or judicial determination before making an investment in the capital stock of the Federal Reserve Bank of the district. It is not improbable that some shareholder would attack the purchase through court proceedings, and after hearing the judicial tribunal might decide the transaction exceeded the authority conferred upon the directors and officers of the bank. This is a possible complication that need not be invited. It will not take long for the various legislatures to clear up this uncertainty and by the time that has been done, the experience of the member banks will have been such as to afford some basis for passing judgment upon the advisability of entering the reserve institution. In this respect the State banks are more fortunate than the National banks, for the subject is not debatable so far as the latter are concerned; they are directed to take the one course or liquidate. That is the only option they may exercise.

Would State banks gain anything by joining the system at this time? They would acquire the right to rediscount certain classes of paper at the Reserve banks, which would be nothing more than another means of securing loans, but as against this, and in consideration of balances maintained, they will continue to receive the same liberal treatment as in the past when applying to National bank correspondents for loans. So that the enlarged facilities for obtaining funds and credits for the accommodation of customers will be open to them, whether members or not, for the National banks will gauge their own rediscounts at the Reserve banks with the idea of extending these favors. It should be remembered that they will be better able to do this than ever before, for there will

